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Comments on the Social Security Notch Issue

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SUMMARY

While differences in benefit amounts exist between cohorts of retirees who came under the benefit rules enacted in the 1977 Amendments to the Social Security Act, and those who continued to have their benefits computed under the pre-1977 rules, such differences do not justify benefit increases for those under the new law. Those beneficiaries under the new law who claim an inequity, in particular the transition (or notch) cohorts born from 1917 to 1921, are comparing their benefit levels to a group that received an unintended windfall from the system as a result of a flawed benefit formula. The notch group generally receives benefit levels that are as high or higher than most cohorts coming before or after them. In fact, many in the notch cohorts are among those that will receive the highest relative benefit levels in the history of the Social Security program. Analyses by social security experts agree with the findings in GAO's 1988 report.

GAO also finds that enacting the proposed notch legislation (H.R.917/S.567) would be costly. The bill would result in the reduction of reserves credited to the Old-Age and Survivors Insurance (OASI) trust fund and could require revenue raising measures, such as a payroll tax increase under the Social Security "firewall" provisions of the 1990 Budget Enforcement Act. A payroll tax increase would have a negative impact on today's workers, who are already paying a substantial tax rate to finance current and future benefits. Measures to finance higher benefits for the notch group also could diminish the ability of the Social Security system to address developing problems in the Disability Insurance fund and the Medicare Hospital Insurance fund. GAO believes that the Congress should neither reduce trust fund reserves nor increase OASI taxes to finance notch legislation.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss our views on the notch issue.

As you know, in April 1986, the previous Chairman of this subcommittee asked GAO to conduct an independent and thorough study of a disparity in Social Security benefits described as the "notch." In his statement requesting our study, the Chairman pledged to review our findings and take appropriate action based on them.[1] After a lengthy study, we issued a report in March 1988, and testified at a hearing on the topic in April 1988.[2] Based on our findings and the testimony given at the hearing, this subcommittee concluded that the notch disparity did not represent an inequity when viewed in the proper historical context of the Social Security program and it chose not to act on notch legislation.

My purpose in appearing here today is to reaffirm our original findings and to tell you that we believe the subcommittee made the correct decision in not advancing notch legislation. It is easy to become embroiled in the technical aspects of the notch issue and the proposed legislation, but I must point out that such legislation presumes a "fix" is warranted. As we have found, this is not the case.

On the matter of how the notch occurred, how it is defined, and whether it constitutes an inequity, we have little to add to our original findings and testimony. The notch cohorts generally fare better than most cohorts coming before and after them. The key point is that they are comparing themselves to a group that got an unintended windfall from the system as a result of a flawed benefit formula. In fact, many in the notch cohorts are among those that will receive the highest relative benefit levels in the history of the Social Security program.

Subsequent analyses by others have confirmed our analysis and provided additional support for our view that beneficiaries in the transition (or notch) group (those born from 1917 to 1921) are not worse off relative to most other Social Security beneficiaries. Notably, there is the 1988 report of the National Academy of Social Insurance, which was the subject of a January 1989 Senate Finance Subcommittee hearing.[3] Also, some very insightful analysis

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[1]Congressional Record, April 29, 1986, p. H-2276.

[2]Social Security: The Notch Issue (GAO/HRD-88-62, Mar. 1988); and The Social Security Notch Issue (GAO/T-HRD-88-14, Apr. 14, 1988).

[3]National Academy of Social Insurance, The Social Security Benefit Notch: A Study, Nov. 1988.

published recently by the Congressional Research Service (CRS) has helped to refine our understanding of benefit comparisons.[4]

In the remainder of my statement, I would like to make a few comments about the proposed notch legislation and factors the Congress should consider in addressing this issue.

THE PROPOSED LEGISLATION: H.R.917/S.567

The current "consensus" notch bill, H.R.917/S.567, aims primarily to supplement the "transitional guarantee" provision of the 1977 Social Security Amendments and provide a "smoother" transition into the current benefit formula.[5] The bill would accomplish this by awarding higher benefits to the original transition group as well as by extending higher benefits to an expanded transition group. In our view, the facts do not support the aims of this legislation.

Notch advocates support their claim to higher benefits by way of a graph showing an apparent "pothole" or dip in benefits for some in the transition group. In examining this so-called pothole, note that rising average wages will generally create a pattern where

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[4]David Koitz and Geoffrey Kollmann, The Social Security Notch Issue: Comparison of Benefits for People Born at Different Times, CRS report, July 15, 1992; Geoffrey Kollmann, Social Security: The Effect of Economic Variations on Benefits, Congressional Research Service Report #92-333, March 27, 1992; and various CRS reports and memoranda co-authored by Koitz and Kollmann: (1) "What Would Social Security Benefit Levels Be Today if New Awards to People Retiring in 1975 and Later Had Risen Only at the Rate That Wages in the Economy Grew?," memorandum dated March 20, 1992, (2) "Examples of Uneven Effects of H.R. 917, a Bill That Addresses the Social Security 'Notch' Issue," memorandum dated November 1, 1991, (3) "The Social Security Notch Issue: Examples of Benefits Levels for People Who Retire at Age 62," memorandum dated July 30, 1991, and (4) The Social Security Notch Issue: Examples of Benefit Levels for People Born From 1895 to 1940, CRS Report #91-541 EPW, July 11, 1991.

[5]The 1977 Amendments to the Social Security Act corrected a flawed (old law) benefit formula. To provide a transition to the (new law) wage-indexed benefit formula, those retirees born in the years 1917-1921 (the transition group) could have their benefit computed two ways: (1) under the new law wage-indexed formula and (2) under a modified version of the old law formula called the transitional guarantee. They would receive the higher of the two computed benefits. The notch refers basically to differences in benefit amounts that occur between adjacent birth cohorts (with similar earnings histories) when benefits are computed under the old law versus the new law formula.

initial Social Security benefits (in constant dollars) will rise for successive birth cohorts over time (see figure 1). The flawed old law formula, because of the way it overindexed benefits during a period of rapid inflation, resulted in higher-than-intended benefit increases. This explains the rapid rise in initial benefit awards for birth cohorts from about 1910 through 1916. The corrected new law wage-indexed formula essentially restored the normal historical pattern. Initial (constant dollar) benefit awards and replacement rates were returned to the levels experienced by those retiring in the mid-1970s. Those in the 1917-1921 birth cohorts get as much or more than earlier birth cohorts, except for those who benefitted from the unintended windfall arising from use of the flawed formula.

Also, as shown in figure 1, those in the so-called pothole appear to receive less than those cohorts who come after them. However, this is due to the effect of rising average wage levels on projected benefits. Successive cohorts of retirees have earned more during their lifetime--in real terms--and, therefore, will receive higher benefits than earlier retirees. A recent CRS study eliminates the effect of rising wages and demonstrates that the notch group generally has a benefit level that is as high or higher than those cohorts coming after them (see figure 2).[6]

The design of H.R.917 addresses the features of the transitional guarantee provision that resulted in its relatively rapid phase out (for example, exclusion of automatic benefit increases between 1978 and age of eligibility and exclusion of post-age 61 earnings in calculating average monthly wages under the old formula).[7] However, the bill has the effect of "fixing," through higher benefit amounts, what results from the current and stable new

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[6]The CRS study computes a benefit level by multiplying each cohorts' replacement rate by the average wage level in 1992. This benefit level computation eliminates the effect of rising wages by assuming a given wage level and that all cohorts retire at the same age and the same time. The pattern of benefits across cohorts reflects the same underlying pattern as replacement rates (that is, initial benefit divided by earnings in the period prior to retirement). See Koitz and Kollmann, The Social Security Notch Issue CRS Report, July 15, 1992.

[7]As we reported in 1988, the transitional guarantee provision did phase out more quickly than anticipated. Rapid price inflation after 1978 continued to drive up the benefits of those under the old law but did not affect the transitional guarantee formula. At the same time, the new law formula, which was driven by wage growth, overtook the transitional guarantee in terms of providing a higher initial benefit. Thus, the 1919-1921 cohorts generally come under the new law formula (see GAO/HRD-88-62, pp. 34-39).

benefit formula.[8] Because beneficiaries in the 1919-1921 (and later) cohorts received benefits calculated under the new law formula rather than the transitional guarantee, does not mean they have been treated inequitably.

We are also concerned that H.R. 917 would extend higher benefits to many others who are now getting the correct amounts under the new law formula. The legislation would do this by (1) extending the modified transition provisions by 5 years to those cohorts born from 1922 to 1926 and (2) introducing a "blended formula" that gives successive cohorts a declining percentage of the difference between the modified old law formula and the new law benefit formula.

We noted in our 1988 report that the use of a blended formula in the 1977 legislation might, in hindsight, have provided a less rapid transition to the new law and extended higher benefits to some individuals in the 1919-1921 cohorts.[9] However, we also stated that a 5-year period for the length of the transition group was adequate and recommended not extending it, as H.R. 917 would do.[10]

FINANCING NOTCH LEGISLATION

The proposed notch legislation is subject to the so-called firewall provisions included in the 1990 Budget Enforcement Act. These procedures, which are different in the House and the Senate, were enacted to prohibit changes in Social Security revenues and expenditures that would reduce the accumulation of trust fund reserves or significantly alter the system's long-term financial status. Unless the firewall provisions are waived by both the House and the Senate, enacting notch legislation would require additional revenue-raising measures, such as increasing the payroll tax on current workers. Today's workers already pay a substantial tax rate to finance future benefits and will get a lower return on their Social Security contributions than earlier cohorts--

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[8]Attempting to alter the benefit formula to achieve equity is not a simple task and can create other differences in benefit amounts. A CRS analysis of H.R.917 (memorandum dated Nov. 1, 1991) shows that the bill can result in differences in benefits for individuals who receive the same benefits under current law. These benefit differences are associated with the way in which different lifetime work patterns interact with the modified old law provisions in the bill.

[9]GAO/HRD-88-62, p. 90.

[10]GAO/HRD-88-62, pp. 92-93.

particularly the windfall and notch groups. Financing notch legislation will worsen the "deal" that today's worker gets from the system.

I would also like to comment on the estimated cost of H.R. 917, in light of the current financial status of Social Security. The Social Security Administration estimates that H.R. 917 will cost $4.6 billion per year in additional benefit payments between 1992 and 1997, and $45.1 billion over the next 10 years. The Old-Age and Survivors Insurance (OASI) trust fund is accumulating at a rate of about $47 billion this year and the annual increment is projected to grow well into the next century. Thus, it might seem to some that additional benefits can be paid for easily.

In our 1988 report,[11] we emphasized that nothing should be done to diminish the trust fund accumulation, which was instituted to assure the benefits of future retirees. We cautioned that the system had yet to attain minimally adequate contingency levels and reducing the trust fund to finance notch legislation could be risky should we enter an economic recession.

We are now at a point, 10 years after Social Security was on the brink of insolvency, where the OASI reserves are at last approaching the minimum short run solvency level of 1-year's benefits.[12] This level is still some way from the upper end of the solvency range suggested by the Social Security Advisory Council Technical Panel.[13] Furthermore, we have now had a recession and this has slowed the reserve accumulation. Consider the cost of notch legislation and ask: What if this legislation had been passed 4 years ago? We can now say that it would have prevented the OASI fund from achieving its current minimum solvency level--Social Security still would not have even minimally adequate reserves.

The financial status of Social Security over the longer term must also be considered. Four years ago, in 1988, the Board of Trustees projected that the OASI fund would not be exhausted until the year 2050. The latest Trustees' Report now projects exhaustion of OASI in 2042. Enacting notch legislation would result in increased costs to extend higher benefits to a number of beneficiaries. This

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[11]GAO/HRD-88-62, p. 91.

[12]This means a ratio of trust fund reserves to annual disbursements equal to 1 or a 100-percent fund ratio.

[13]While recommending a "target" fund ratio of 100 percent, the Panel of Technical Experts suggested to the 1991 Advisory Council that a fund ratio of 135 percent may be necessary to protect against adverse short run contingencies. See The Social Security Technical Panel Report to the 1991 Advisory Council on Social Security, Washington, D.C.

would advance the OASI trust fund's projected exhaustion date and, it would put greater pressure on other Social Security programs that may soon be facing the need for expanded revenues.

The trend in the Disability Insurance (DI) fund is of particular concern. In 1988, the DI fund was not projected to be exhausted until 2027. Due largely to unfavorable trends in the DI program, the latest Trustees' Report shows the fund exhausted in 1997. In addition, the Medicare Hospital Insurance (HI) fund is projected to decline rapidly and become exhausted by 2002. Future actions will be necessary to keep these programs financially sound.

Let me emphasize that our Social Security system is financially sound, and this is a result of the actions and continuing oversight of the Congress. But given the current status of the OASI fund, the recent adverse developments in the DI fund, and the ongoing concerns over Medicare, financing higher benefits for the notch cohorts would exacerbate financial pressures on the Social Security system and today's workers. Therefore, we do not believe the Congress should diminish the trust fund or raise OASI taxes to finance notch legislation.

This completes my statement Mr. Chairman. I would be glad to answer any questions the subcommittee might have.

Figure 1

GAO Social Security Benefits For Age – 65 Retirees With Average Earnings

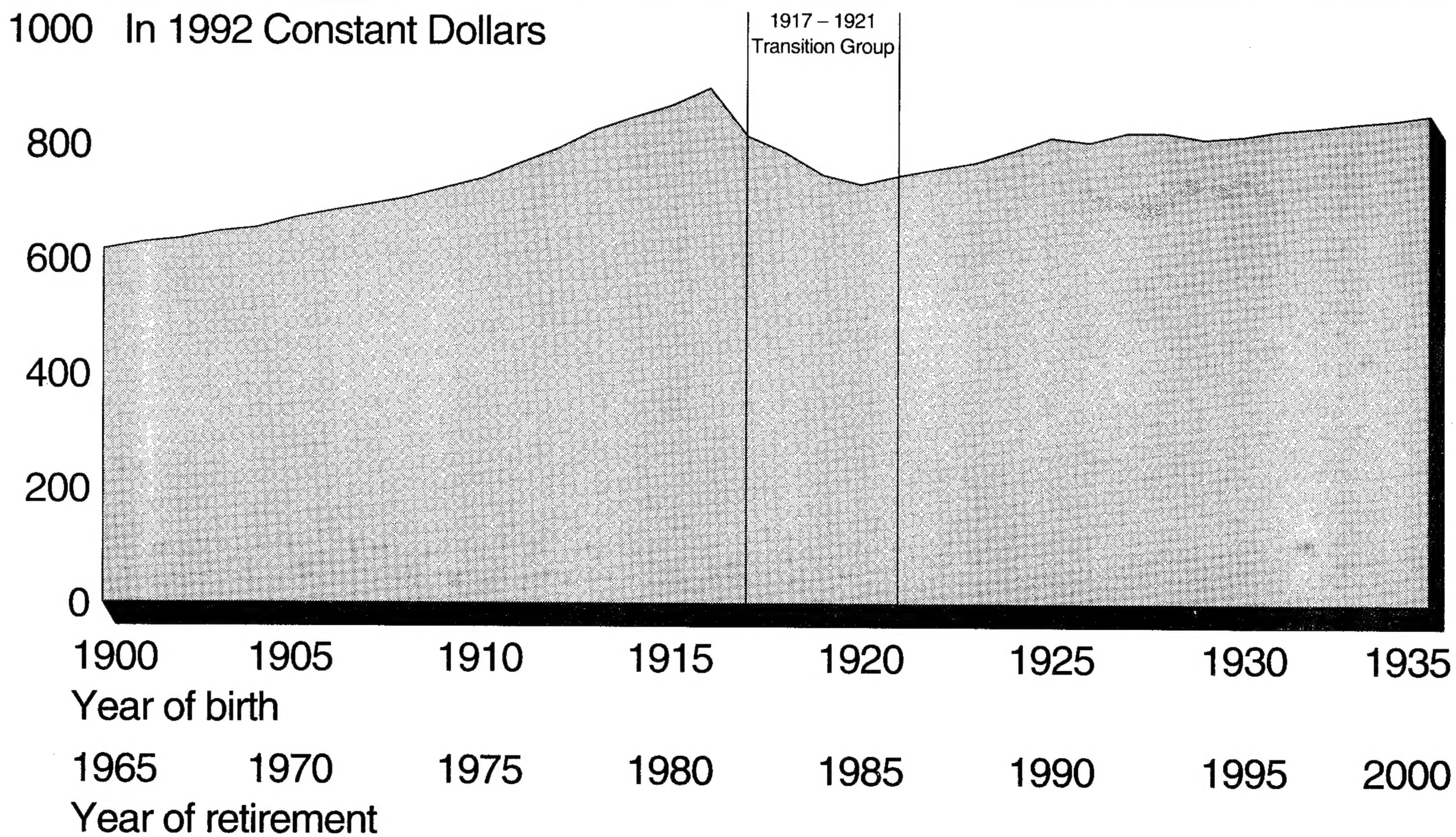
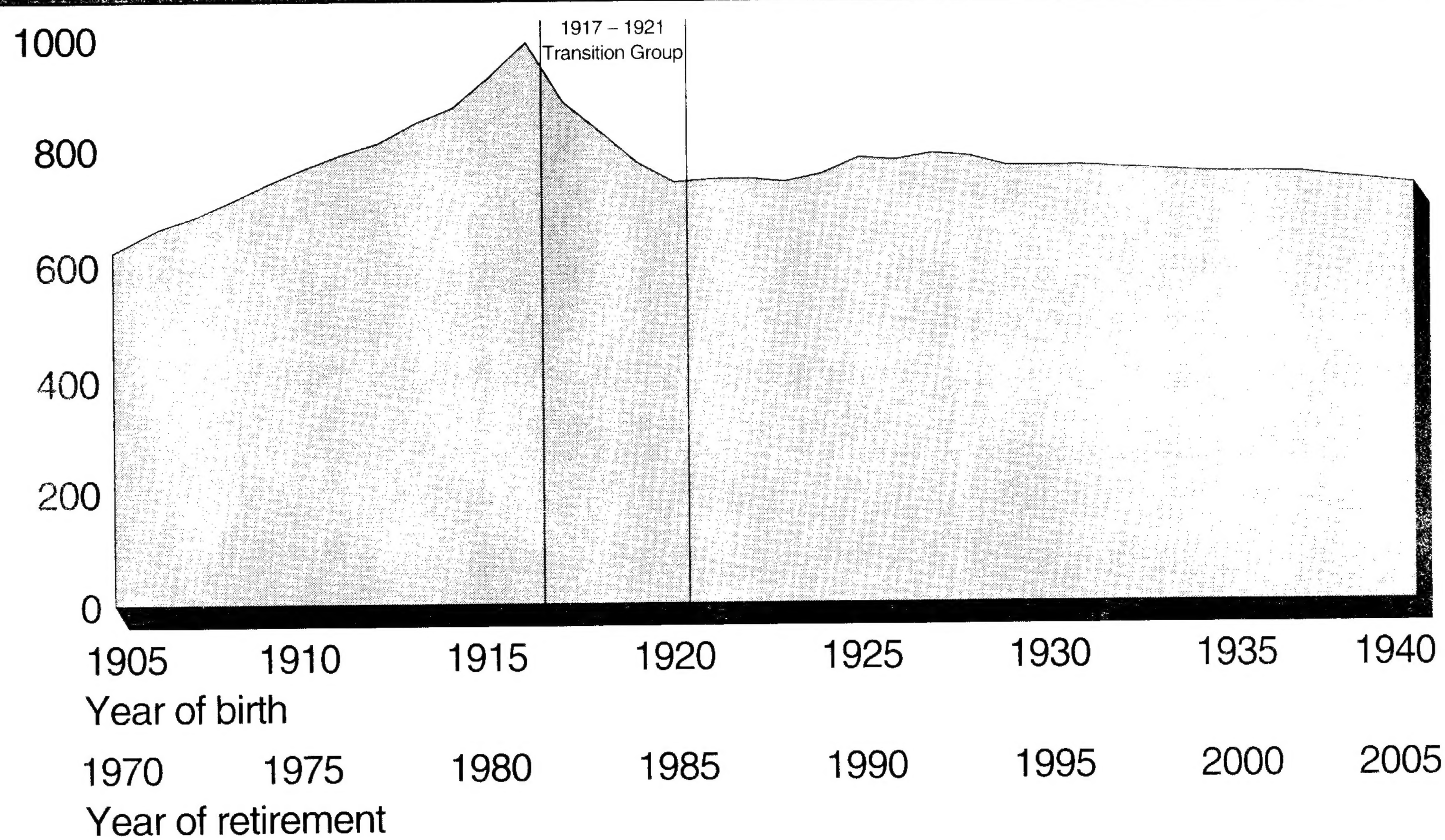


Figure 2

GAO Social Security Benefits If Workers Retired At Same Age And Time



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